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IMPORTANT NOTE: This Memorandum is intended to provide a guide to the main features of the Securities and Futures Ordinance. It should not be relied upon as a substitute for legal advice.

If you would like us to provide advice and/or a presentation which covers the issues described in this Memorandum in more detail, please contact your usual adviser at Slaughter and May, main switchboard number +852 2521 0551. The contact details of our offices appear at the end of this Memorandum.
SEcurities and Futures Ordinance

Consolidating and modernising

The Securities and Futures Ordinance (“SFO”), which came into force on 1 April, 2003, consolidates into one piece of legislation the ten ordinances that previously regulated the securities and futures industry in Hong Kong. More importantly, the SFO has modernised much of the principal legislation. The changes to the licensing regime have been well documented and as have the increased disclosure obligations imposed on substantial shareholders and directors of Hong Kong listed companies. However, there are also significant changes to market misconduct laws, including the ways in which market misconduct will now be dealt with. For example, company officers are now required to take steps to prevent market misconduct by their company.

As a result of these changes, and the increased powers of supervision and investigation of the Securities and Futures Commission (“SFC”), it is more important than ever for market participants, directors, compliance officers and shareholders in listed companies to ensure that they have proper procedures in place to ensure compliance with the new provisions.

More to come?

Structurally, much of the SFO is a framework; much of the detail is included in schedules and subsidiary legislation which can be changed easily to accommodate market developments. To date, forty pieces of subsidiary legislation have come into force. Now that the framework has been established, we expect further change to follow.
SECURITIES AND FUTURES COMMISSION

The SFC remains the principal regulator of the Hong Kong securities and futures industry.

Regulatory objectives

For the first time, the regulatory objectives of the SFC are set out in legislation. These include, in relation to the securities and futures industry:

- to maintain and promote its fairness, efficiency and transparency;
- to suppress illegal and improper practices;
- to supervise, monitor and regulate the activities of industry participants;
- to promote and develop self-regulation; and
- to encourage the provision of sound, balanced and informed advice.

Who does it regulate?

Under the SFO, the SFC is given the authority to supervise, monitor and regulate the activities of industry participants, including:

- exchange companies (currently the Hong Kong Stock Exchange and the Hong Kong Futures Exchange);
- clearing houses (e.g. Hong Kong Securities Clearing Company Limited, Hong Kong Futures Clearing Corporation and the Stock Exchange Options Clearing House);
- recognised exchange controllers (Hong Kong Exchanges and Clearing Limited);
- recognised investor compensation companies (the new Investor Compensation Fund);
- providers of automated trading services (so far, no provider of automated trading services operating as a trading network has been authorised); and
- licensed persons (e.g. dealers and investment advisers) and registered institutions (e.g. banks).

Impact on the Stock Exchange

The Stock Exchange may continue to make rules in relation to matters affecting listed companies and exchange participants. These rules are, however, subject to prior approval by the SFC and the SFC has an express power to make rules in respect of the same matters.
In addition, under subsidiary legislation, listing applications and other documents (including circulars, accounts and announcements) issued by listed companies will now need to be filed with the SFC as well as the Stock Exchange.

Any doubt about which of the two regulators would emerge triumphant from this apparent jurisdictional battle has seemingly been resolved by the Report by the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure. This has recommended that a new division of the SFC (the Hong Kong Listing Authority) assume the listing function, a recommendation which has been accepted by the Government (despite continued Stock Exchange opposition).

**Supervision and investigations**

The SFC has enhanced powers to require information and to conduct investigations.

These powers extend to:

- directing a listed corporation (and its related corporations) to produce records and documents where it appears to the SFC that fraud has taken place in relation to the listed corporation’s business. The direction can also be given to any person, including the corporation’s bankers and auditors;

- entering the premises of an intermediary to inspect, make copies or record details of any relevant document or record and make inquiries in each case to monitor compliance with the SFO. There are similar powers in relation to registered institutions, exercisable by the Hong Kong Monetary Authority (“HKMA”);

- requiring information from certain persons (including intermediaries) to enable or assist the SFC to carry out any of its functions; and

- investigating offences and other misconduct in connection with activities involving securities, futures contracts and certain other financial products. (Before exercising its investigative powers, the SFC must consult the HKMA if the investigation relates to any alleged misconduct by a registered institution or under the Banking Ordinance.)

To enforce the SFC’s powers, the SFO creates a number of offences for non-compliance with a SFC request for relevant information or the provision of materially false or misleading information (which may lead to a fine and/or imprisonment), and empowers the SFC to seek a court order requiring production of relevant information.

**Discipline**

The SFC’s powers to discipline licensed persons for misconduct or for conduct that reflects on their fitness and properness are preserved and supplemented.
The range of disciplinary powers available to the SFC to deal with improper conduct now includes:

> the suspension or revocation of an intermediary’s licence and/or a responsible officer’s approval;

> the making of prohibition orders; and

> the levying of civil fines (up to the higher of $10 million and 3 times the profit gained/loss avoided as a result of the improper conduct).

In addition, the SFC can suspend or revoke a licensed person’s licence in the event of the licensed person’s insolvency and on the occurrence of certain other events which go to the fitness and properness of the licensed person.

Appeals can be made to the Securities and Futures Appeals Tribunal (see page 11).

The disciplinary regime now applies to banks and other authorised institutions which have been registered to carry on one or more regulated activity.

Powers of intervention and proceedings

The SFC may continue to intervene in the business or affairs of licensed corporations. The SFC may by written notice prohibit a licensed corporation from undertaking certain specified activities, including dealing with certain property, or require the licensed corporation to carry on its business in a specified manner.

The powers of the SFC to apply to the courts for certain orders, including injunctions, and winding up or bankruptcy orders, are also retained.

The SFC is given a new power to apply to the Court of First Instance for an order requiring a person to comply with the SFC’s prohibition or requirement. The Court may, if it is satisfied that the failure is without reasonable excuse, punish a person for such non-compliance.
REGULATION OF OFFERS OF INVESTMENTS

Investment advertisements

The issue to the public of investment advertisements continues to be regulated in much the same way as before.

Inducing others to invest money

It is still an offence fraudulently or recklessly to induce persons to invest money. In addition, there are civil consequences for inducing a person to invest money by way of a fraudulent, reckless or negligent misrepresentation.

Issue of investment advertisements

The general rule is still that investment advertisements must be authorised by the SFC. The exceptions are broadly unchanged and include investment advertisements made or issued by licensed persons, although these are now more specific, in line with the new licensing regime which restricts licensees to carrying on the regulated activities for which they are licensed.

Professional investors

There is still an exception for investment advertisements relating to securities (as well as interests in collective investment schemes and regulated investment agreements) which are, or are intended to be, disposed of only to professional investors. However, the definition of professional investor is much changed. The exception now only applies to certain categories of market participants. Under subsidiary legislation, the SFC has extended the list of professional investors to include certain high net worth companies and partnerships (with investment portfolios of not less than $8 million or total assets of not less than $40 million), trust companies (holding assets of not less than $40 million) and individuals (with investment portfolios of not less than $8 million).

There are, as yet, no corresponding changes to the prospectus provisions of the Companies Ordinance although a consultation paper has been issued by the SFC which proposes bringing these provisions more into line with the SFO.

Also of interest is the exemption available for “conduits” and live broadcasters who, without changing their contents, publish unauthorised investment advertisements in the ordinary course of their business.

Collective investment schemes

Under the SFO, all funds to be marketed to the public in Hong Kong continue to require authorisation from the SFC.
Although the Code on Unit Trusts and Mutual Funds will not (for the moment) be renamed, the SFO introduces the new statutory definition of collective investment scheme. This extends not only to the traditional structures of unit trusts and mutual funds, but to all other “pooling” structures which do not adopt either structure. Although the new definition appears broad enough to capture closed-ended investment companies, it is unlikely that these will be authorised under the new regime.

Under the SFO, each Hong Kong authorised collective investment scheme must appoint an “approved person” for the purposes of receiving communications from the SFC. There is a continuing obligation to provide to the SFC, and keep up to date, the approved person’s contact details.

Unit trusts and mutual funds authorised under the Securities Ordinance will be deemed to be authorised under the SFO. However, in order to receive the benefit of the deeming provision, existing authorised funds must ensure that an approved person is nominated to and accepted by the SFC within a grace period which expires on 30 September, 2003.
LICENSING AND REGISTRATION

Single licence

The SFO introduces a “single licence concept”. Under the old regime, there were twelve types of licence available under four ordinances; under the SFO, there is only one. The licence will authorise the carrying on of one or more of nine regulated activities by a corporation. In theory, therefore, a corporation can carry on a number of different regulated activities under the same licence. In practice, however, there remain significant logistical and regulatory hurdles to overcome before this becomes a reality. For example, the business of securities margin financing can only be conducted within a single purpose entity. There are also regulatory problems in combining certain other activities within the same entity, thus making it practically impossible for a licensee to carry on these activities under one licence.

Carrying on a business in a regulated activity (or holding oneself out as carrying on such a business) without a licence which permits the carrying on of that regulated activity, and without reasonable excuse, is a criminal offence.

There is a two-year transitional period for existing registrants to migrate to the new licensing regime. However, a group holding a number of existing licences will not simply be able to take advantage of the transitional deeming arrangements to consolidate its operations into one licensee - the licensee will need to convince the SFC that it has the necessary resources and expertise to carry on the regulated activities which it did not previously conduct.

During the transitional period, the licences of unincorporated persons will be phased out.

The new regulated activities

There are nine regulated activities:

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<td>advising on corporate finance</td>
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<td>Type 7</td>
<td>providing automated trading services</td>
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<td>Type 8</td>
<td>securities margin financing</td>
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<td>Type 9</td>
<td>asset management</td>
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Providing automated trading services is a new regulated activity for which a licence was not previously available.
How does the new licensing regime affect banks?

Authorised financial institutions (including banks) are for the first time required to be registered with the SFC if they wish to carry on one or more regulated activity (other than Type 3 or Type 8 regulated activities). (Previously, banks relied upon exempt dealer or investment adviser status, both of which are abolished by the SFO). Authorised financial institutions will need to apply to be registered under the SFO (and will be called “registered institutions”). As a result of this change, registered institutions are now regulated by the SFC and the HKMA jointly (although their banking operations will continue to be regulated by the HKMA).

Licensed representatives and responsible officers

Any individual who carries on a regulated activity on behalf of a licensed corporation is required to apply to the SFC for approval to be a licensed representative accredited to that corporation. In addition, every licensed corporation must have at least two responsible officers in relation to each regulated activity for which it is licensed, at least one of whom must be an executive director. A responsible officer is any officer who supervises the business of the regulated activity for which the corporation is licensed (and who is required to be available for such purposes at all times). An executive director is a director of a licensed corporation who actively participates in or is responsible for directly supervising the regulated activities of that licensed corporation.
CAPITAL REQUIREMENTS, CLIENT ASSETS, RECORDS AND AUDIT RELATING TO INTERMEDIARIES

New financial resources regime

Licensed corporations are subject to a uniform financial resources regime, set out in subsidiary legislation (rather than in the SFO itself). This new financial resources regime is based on the financial resources rules that previously applied to securities and futures dealers and advisers and to leveraged foreign exchange traders.

The new regime contains detailed paid-up share capital and liquid capital requirements. (The liquid capital requirements replace the net tangible assets requirement which previously applied to certain registered persons.)

The requirements are less onerous for advisers and asset managers that do not hold client assets. There is a transitional period of six months for advisers not holding client assets to move to the new liquid capital requirements and for exempt dealers and exempt investment advisers who are not authorised institutions to comply with the new rules.

Client assets

The SFC has made rules regarding client securities and client money held by a licensed corporation or a registered institution.

Record keeping

The SFC has created a framework of rules regulating the keeping of accounts and records by intermediaries and associated entities, and the preparation and provision to clients of contract notes, receipts and statements of account.

Audit

Licensed corporations must appoint an auditor. However, the SFC may appoint its own auditor to a licensed corporation where it is concerned that there has been a failure by the licensed corporation to comply with the prescribed requirements, or on a client’s request.
BUSINESS CONDUCT OF INTERMEDIARIES

The SFC has been given the power to make statutory rules in addition to publishing codes of conduct applying to licensed persons and registered institutions. The SFC has published a code of conduct in relation to corporate finance advisers and has updated its code of conduct on persons licensed by or registered with the SFC. While a breach of a rule will be subject to criminal sanctions, a breach of a code of conduct may itself result in disciplinary action by the SFC and could call into question the fitness and properness of a licensed person.

Short selling

The restrictions on short selling in the SFO are essentially unchanged. Clarification is now provided as to which actions are to be regarded as selling securities, and what it means to have a presently exercisable and unconditional right to vest securities.

Unsolicited calls

The previous restrictions on cold calling and hawking of securities have been combined into the new provisions governing unsolicited calls.

The new provisions prohibit licensed corporations and registered institutions from making investment agreements during, or as a consequence of, an unsolicited call or visit; as a result, any such agreements may be rescinded. A call is unsolicited if made otherwise than at the express invitation of the person called upon. Calls on solicitors or accountants (acting in their professional capacity), other licensed persons or registered institutions, money lenders or professional investors are exempted. Calls on existing clients of the intermediary are also exempted.

Options trading

The SFC has been given power to make rules prohibiting options trading by certain intermediaries. There are no such rules at present.
SECURITIES AND FUTURES APPEALS TRIBUNAL

The SFO establishes the Securities and Futures Appeals Tribunal ("SFAT").

Powers

The SFAT hears appeals from certain decisions of the SFC, the HKMA and the Investor Compensation Fund (see page 12), including decisions of the SFC refusing to grant a licence or imposing conditions on a licence. Appeals from the SFAT are to the Court of Appeal on matters of law.

Constitution

The SFAT is an independent full time tribunal chaired by a judge and including two lay members.

The SFAT is able to require witnesses to attend and testify or produce evidence to it. It has the power to set aside or vary any decision made by the SFC, HKMA or the Investor Compensation Fund or to remit back a matter with instructions to revisit the decision.
INVESTOR COMPENSATION

The SFC is required to establish and maintain a new fund, to be called the Investor Compensation Fund, to provide some measure of compensation to clients of intermediaries who suffer loss by reason of default of intermediaries. The basis for making claims will largely follow the existing arrangements for the existing funds (which will be replaced once the new fund is in place and all claims against the existing funds are settled).

However, the Investor Compensation Fund extends to a wider range of intermediaries (not only exchange participants) and to a wider range of products (not only exchange-traded products). The new fund also has a per-investor compensation limit ($150,000) rather than a per-exchange participant limit.
OFFENCES RELATING TO SECURITIES AND FUTURES CONTRACTS, ETC.

A civil and a criminal regime

The SFO creates and governs the Market Misconduct Tribunal which has the power to impose civil sanctions for various types of market misconduct. The SFO also contains a parallel criminal regime. There will, however, be no "double jeopardy" under the two regimes. The final decision whether to institute criminal or civil proceedings rests with the Department of Justice ("DoJ") based on reports prepared by the SFC and provided to the Financial Secretary (civil) or the DoJ (criminal).

The Market Misconduct Tribunal

Jurisdiction

The Market Misconduct Tribunal ("MMT"), which is based on the Insider Dealing Tribunal, hears and determines issues arising out of proceedings brought by the Financial Secretary, including determining:

- whether any market misconduct has taken place;
- the identity of the person engaged in market misconduct; and
- the amount of profit gained or loss avoided as a result of market misconduct.

Standard of proof

The MMT is to apply the civil standard of proof (i.e. balance of probabilities) in determining any question or issue before it.

Powers

The MMT has wide powers, including:

- receiving and considering any material as evidence even if it would be inadmissible in court proceedings;
- requiring attendance and production of evidence or material by any person; and
- examining on oath or otherwise a person attending before the MMT.

Failure to comply with an order, notice, prohibition or requirement of the MMT or disrupting or interfering in its operations or proceedings, is a criminal offence. An offender is liable on conviction to a fine and imprisonment. Self incrimination is not an excuse for non-compliance with a MMT order, notice, prohibition or requirement.
Appeals

Appeals are to the Court of Appeal on a point of law or, with the leave of the Court of Appeal, on a question of fact.

Orders

The MMT can make various orders, including:

> disqualification as an officer of a listed corporation for up to five years;

> prohibiting dealing in any securities, futures or leveraged foreign exchange contracts or interests in collective investment schemes for up to five years;

> prohibiting further market misconduct;

> disgorgement of the amount of any profit gained or loss avoided as a result of the market misconduct;

> payment of SFC’s costs; and

> recommendation of disciplinary action by an appropriate regulatory body.

Third party actions in the courts are permitted. A person who has “committed a relevant act in relation to market misconduct” is liable to pay compensation by way of damages to any other person for any pecuniary loss sustained by the other person as a result of the market misconduct. The proceedings of the MMT are admissible in such cases.

Insider dealing and types of market misconduct

Insider dealing

The insider dealing provisions in the SFO, in particular the elements constituting insider dealing, are essentially unchanged from their predecessors. However, the definition of listed securities now extends to issued but unlisted shares of a listed corporation as well as, in some cases, its unissued shares.

In addition, there has been some welcome clarification. For example, it is now express that relevant information can include information about the shareholders or officers of the relevant listed corporation.

The defences to insider dealing have been clarified and expanded. In particular, a defence is now available to a person who deals in securities using market information arising directly out of his own trading or trading intentions.
Market misconduct

The five forms of market misconduct are:

> false trading (intentionally or recklessly creating a false or misleading appearance of active trading in, or with respect to the market for, or the price for dealing in, traded securities/futures contracts);

> price rigging (carrying out any sale or purchase of securities that does not involve a change of beneficial ownership of those securities and which affects the price of securities or carrying out any other fictitious transaction with the intention of affecting, or being reckless as to whether it affects, the price of traded securities/future contracts);

> disclosing information about prohibited transactions (disclosure of information to the effect that the price of traded securities/futures contracts, will, or is likely to, be affected because of a prohibited transaction. A “prohibited transaction” means any conduct or transaction which constitutes market misconduct);

> disclosing false or misleading information inducing transactions (intentional, reckless or negligent disclosure of false or misleading information that is likely to induce the sale, purchase, subscription etc. of securities/futures contracts or to affect the price of securities/futures contracts); and

> stock market manipulation (carrying out two or more transactions in securities of a corporation that affect the price of any traded securities with the intention of inducing another person to buy or sell (or refrain from buying or selling) securities of the corporation or of its related corporation).

Every officer of a corporation (including any director, company secretary or any other person involved in its management) is required to take all reasonable measures from time to time to ensure that proper safeguards exist to prevent the corporation from perpetrating market misconduct.

Stabilisation

Under subsidiary legislation, there are finally detailed safe harbour guidelines in relation to price stabilisation which bring Hong Kong more into line with international practice.

The criminal regime

The criminal provisions broadly mirror the civil market misconduct provisions, although there are some differences.

The offence of disclosure of false or misleading information inducing transactions excludes negligent disclosure and only catches a person who knows or is reckless as to whether the information is false or misleading.
The penalties for committing an offence under the criminal regime are more severe than the sanctions under the civil regime.

The criminal regime creates additional offences for:

> employing any fraudulent or deceptive devices, etc. in transactions involving securities, futures contracts or leveraged foreign exchange trading;

> disclosure of false or misleading information inducing others to enter into leveraged foreign exchange contracts; and

> falsely representing dealings in futures contracts on behalf of others.
DISCLOSURE OF INTERESTS

The previous regime for disclosure of interests in listed corporations has been replaced by a new and expanded disclosure regime in the SFO. The stated aim is to improve the quality, timeliness and the reliability of disclosed information.

Who does the new regime apply to?

As before, the regime applies to substantial shareholders and directors and chief executives. However, the threshold for substantial shareholder disclosure has been reduced to 5% (from 10%). Directors and chief executives are required to disclose interests in any shares or debentures of a listed corporation or an associated corporation.

What interests need to be disclosed?

The new disclosure regime requires disclosure of:

> interests in shares in listed corporations in which a substantial shareholder, or a director or chief executive, is interested;

> interests in debentures of listed corporations in which a director or chief executive is interested;

> interests in shares in listed corporations in which a substantial shareholder, or a director or chief executive, is interested through equity derivatives;

> interests in shares or debentures of an associated corporation of a listed corporation in which a director or chief executive is interested;

> interests in shares underlying cash settled derivatives and interests in unissued shares in listed corporations; and

> short positions (which cannot be netted off against long positions) held by a substantial shareholder, or a director or chief executive.

In addition, a change in the nature of an interest in shares in which a substantial shareholder has a notifiable interest is now required to be disclosed.

Disclosable concert party agreements are extended to include any arrangement under which a controlling shareholder of a listed corporation provides a loan, or security for a loan, to enable another person to buy shares in the same listed corporation.

Interests in shares pledged to a lender would become discloseable where the lender is entitled to exercise voting rights following a default by the borrower and has shown an intention, or taken any step, to exercise the voting rights, or the power of sale is exercisable and the lender offers the shares for sale.
Disclosure periods

The disclosure period has been shortened from five days to three business days following a relevant event (in most cases, an acquisition or disposal of interests). In certain circumstances (where the disclosure obligation is triggered by an external event) the disclosure period is ten business days. Disclosures must be filed with the Stock Exchange and the listed corporation concerned at the same time or one immediately after the other.

Exemptions and exclusions

There is subsidiary legislation enacted under the SFO which provides for exclusions from, and relaxation of, the disclosure regime in certain circumstances. The Securities and Futures (Disclosure of Interests—Securities Borrowing and Lending) Rules set out a relaxed disclosure regime applicable to securities borrowing and lending, while the Securities and Futures (Disclosure of Interests—Exclusions) Regulation sets out prescribed interests and short positions which are to be disregarded for disclosure purposes.

There are specific provisions in the SFO exempting substantial shareholders from disclosure obligations, including:

> a de-minimis exemption from disclosing small changes in interests;

> a group exemption for wholly-owned subsidiaries in connection with transactions between members of a wholly-owned group of companies;

> an exemption for shareholders who receive and take up rights under qualifying bonus and rights issues;

> an exemption for investment managers, custodians or trustees that exercise investment decisions in connection with interests held on behalf of a person; and

> an exemption for holders, trustees and custodians of collective investment schemes.

The obligation on a parent company to aggregate interests of controlled corporations that are investment managers, custodians or trustees and manage their interests independently is now removed. The exemption for security interests is widened to include margin financing and security interests held by certain overseas persons.

There are also specific disclosure exemptions for directors and chief executives who hold certain interests, including:

> interests held as a bare trustee; and

> interests in shares or units in, or as trustees or custodians of, collective investment schemes.
The SFC has published Guidelines for the Exemption of Listed Corporations from Part XV of the Securities and Futures Ordinance (Disclosure of Interests), which set out two categories of circumstances (dual listings and issuers of securities other than shares) under which it will consider granting exemptions (complete or partial), as well as the general criteria and the specific factors (relevant to each category), which it will take into account.

**Power to investigate listed corporation’s ownership**

There are new provisions relating to the keeping of registers by listed corporations of interests notified to them by substantial shareholders and directors and chief executives. In addition, listed corporations and, in certain circumstances, the Financial Secretary have powers to investigate the ownership of listed corporations.

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